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Turning Taxable Wages Into Tax-Free Benefits:

Tax-Advantaged Health Care Expense Trust Accounts For Public Employees

A Report to the 57th Legislature
from the
State Administration, Public Retirement Systems,
and Veterans' Affairs Interim Committee: 1999-2000

November 2000

Prepared by
Montana Legislative Services Division
State Capitol, Room 110
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EXECUTIVE SUMMARY

Study objective

The 56th Legislature, in House Bill No. 79, directed that an interim legislative committee examine "options for addressing the cost of postretirement health insurance and other medical care for public retirees".*

Issue history

Tip of the iceberg: The issue of postretirement health care costs emerged during the 1997-1998 interim when the Committee on Public Employee Retirement Systems (CPERS) commissioned numerous focus groups across Montana to discuss options for reforming the Public Employees' Retirement System (PERS), the largest of Montana's public employee retirement systems. Serious concern about escalating health care costs, which consume an ever-growing proportion of retirement income, was a common theme.

Initial considerations: In response to its findings and based on a consultant recommendation, CPERS began to initially explore options for developing a postretirement health care plan for PERS retirees. CPERS's consultants recommended various tax-advantaged financing vehicles, but CPERS did not have time to adequately consider plan design and funding implications. Consequently, the issue of postretirement health care costs was included in HB 79 as a study directive.

Study process

The Legislative Council assigned the postretirement health care study to the State Administration, Public Retirement Systems, and Veterans' Affairs Interim Committee (SAIC), the successor to CPERS. The SAIC appointed a

* Chapter 471, Laws of 1999, section 63(3)(a).

subcommittee to conduct the study and develop recommendations. The subcommittee received staff background and research reports, solicited testimony from agencies, unions, and local government representatives, and hired a consultant from Ice Miller Donaido & Ryan to provide expert advise on the specifics of plan design options, funding methods, and tax implications under the Internal Revenue Code (IRC).

Final recommendation: A health care expense plan

After examining several different retiree health care plan financing vehicles, the SAIC recommends that the 57th Legislature enact LC 198 to establish an employee benefit plan consisting of individual health care expense trust accounts. Under the SAIC's proposed legislation, these health care expense accounts would be invested by participating public employees, who could then use the principle and earnings to pay qualified health care expenses, including health insurance premiums, copayments, and deductibles. Assuming that the proposed health care plan is determined by the Internal Revenue Service (IRS) to be tax-qualified, employer contributions to the accounts, investment earnings, and payments from the accounts for qualified health care expenses would be tax-free.

Bill summary

LC 198 directs the Department of Administration to establish a statewide employee benefit plan under a Voluntary Employees' Beneficiary Association (VEBA).

Plan provisions: The VEBA plan would be available to all public employees and would provide for the following:

- an individual health care expense trust account for each plan member;

- a VEBA member could designate unused sick leave credits accrued in excess of 120 hours for conversion to tax-exempt employer contributions to the member's VEBA account;

- each member could allocate contributions among the investment options offered under the plan, and investment earnings would accrue tax free;

- account balances could be carried over each year, and a member, whether actively employed or retired, could access the member's account at any time to pay qualified health care expenses (i.e., medical costs allowable under the IRC*);

- distributions from the accounts for payment of qualified health care expenses for plan members, their dependents, and their beneficiaries would be tax-exempt; and

- a member's account would be portable from employer to employer and also available after retirement, until funds in the account are exhausted.

Employee and employer participation: Plan participation would be determined by employees, who would petition their employer for an election on whether to join the plan. If a majority of the employees in the voting group vote to participate in the plan, then all of the voting employees would become plan members. The employer would then contract with the Department of Administration for participation in the statewide plan.

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* Qualified health care expenses allowable under 26 U.S.C. 213(d) include costs for the "diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body", transportation for medical-related exams and procedures, and health insurance, including supplemental insurance.

Contribution amounts: Each plan member would annually designate a certain number of accumulated sick leave hours (over the minimum required balance of 120 hours) for conversion to employer contributions to the member's health care expense trust account. Employer contributions would be 25% of the pay attributed to the sick leave hours, which is consistent with current statutes entitling employees to a lump-sum cash-out of 25% of the employee's unused sick leave upon termination. Employers would not be prohibited from negotiating with plan members for additional employer contributions to the health care expense trust accounts.

Limitations and precautions

The VEBA plan would be limited in some respects. Specifically:

- Under the IRC, employee contributions are NOT tax-free, only the employer's contributions are tax-exempt.

- To provide a buffer against unanticipated needs for employees to take sick leave, the SAIC recommends that employees be required to maintain a minimum of 120 hours (3 weeks) of sick leave, which, at an accrual rate of 3.69 hours every 2 weeks (or 96 hours a year), would take an employee nearly a year and a half to accumulate.

- To mitigate the financial impact on employers with employees who have hundreds of hours of unused sick leave (there is no limit on the amount of sick leave an employee may accrue), the SAIC recommends that the Department of Administration set by rule a maximum amount of sick leave that may be converted at one time.

- If sick leave conversions remain the only funding source and depending on when and how often members choose to access their accounts, member account balances could be exhausted within just a few years, thus undermining the capability of the member to realize significant investment gains.

- The state's current sick leave pool and direct sick leave grant program is voluntary and could be negatively impacted by funding the VEBA plan with sick leave conversions.

- Some public employees, most notably teachers, do not accrue sick leave. Furthermore, some public employees, especially employees with large families, may not have and may never accrue enough unused sick leave hours to fund their health care expense trust accounts.

- Only current active employees may become plan members, thus current retirees will not benefit from this approach.

- The plan is subject to tax-qualification standards imposed by the IRS. Thus, a favorable determination from the IRS is required before the plan can become operational.

VEBA advantages over other plans

Employer tax-advantage: The VEBA plan offers a means whereby employers may make tax-free contributions to employee accounts in lieu of taxable wage increases or lump-sum cash-outs at termination. The employer, therefore, would not have to pay taxes and benefits, which can total about 12% to 14% of pay, on amounts contributed to a VEBA account.

Investment earnings and carryover: Unlike a flexible spending account, an employee with a VEBA account can invest money in the account and accrue tax-free earnings. Also, account balances can be carried over year to year, while a flexible spending account is a "use it or lose it" arrangement.

Not tied to a pension plan and portability: Retiree health benefits may be provided for under a pension plan by establishing a 401(h) account from which retirees can pay their health care expenses. However, contributions

to a 401(h) plan count against IRS limits on how much money may be contributed to and paid from the pension plan. Also, 401(h) accounts are not portable. Funding to and payments from a VEBA plan do not have to be coordinated with a pension plan; and the VEBA accounts are portable in the sense that a VEBA plan member can access the account regardless of pension plan membership or employer.

In summary

Escalating health care costs and increasing health insurance premiums present a significant challenge to employers, employees, and retirees. Employers are under increasing pressure to increase salaries and pension benefits to help offset health care cost increases. However, salary increases mean additional tax and benefit payments for the employer and employee. And, pension income is a taxable benefit to retirees. Therefore, the SAIC recommends that the 57th Legislature enact LC 198 to establish a VEBA benefit plan that will allow public employers to turn otherwise taxable wages into tax-free benefits.

CHAPTER 1:
BACKGROUND RESEARCH

Boomers nearing retirement

A key concern among many analysts, retirees, and workers approaching retirement is that retirement income will not keep pace with the faster increases in health insurance premiums and other medical expenses. What are some of the indicators that analysts are looking at? For starters, our country's 76 million Baby Boomers are turning 50 years old at a rate of one every 7.7 seconds. And, when these baby boomers hit retirement sometime in the next decade, the population of people age 65 and older will likely double.[1]

Western states most affected

The effect of America's aging will be particularly profound in western states. According to census data and analyst estimates of demographic changes between 1995 and 2025, Montana is in the midst of experiencing a 140% increase in the number of people age 65 and older.[2] And, if these numbers fail to spark concern, consider this: Although many admit that the financial health of retirees is relatively good now, at least compared to previous generations, in 1988 (more than 10 years ago) 33% of all public health care expenditures were for the elderly.[3] This percentage is skyrocketing as our nation enters the new millennium.

Health care costs consume increasing proportion of pension income

For many retirees, trying to make ends meet on a fixed pension income and the added financial strain of rising medical costs can be overwhelming. According to research collected by the Congressional Budget Office, in 1987, about 94% of people age 65 and older incurred medical expenses (not including long-term care) averaging $4,600 annually.[4] But, since then, and for the foreseeable future, health care costs continue to climb at a rate

of about 2 to 2 1/2 times the rate of inflation, which has hovered at about 2% to 3% annually.* Furthermore, married couples with children will likely see health care expenses increase at a rate of 5.5% above the rate of inflation, while single-parent families will see expenses increase by as much as 10% more than the inflation rate.[5]

A bit of good news is that Baby Boomers have also experienced a strong growth in real wages and will reap higher Social Security benefits and government programs will cover a large portion of medical expenses. But, the bad news is that Medicare (the primary health care program for virtually everyone age 65 and older) still covers only 48% of average medical expenses, leaving more than half of a retiree's health care expenses to be paid from other sources (i.e., supplemental insurance or a combination of Social Security, personal savings, pensions, and other income). Moreover, Baby Boomers have saved less, are predicted to retire earlier, and will live longer.[6]

Further analysis of the numbers indicate that, while in 1987 more than 20% of a person's postretirement medical expenses had to be paid out-of-pocket,[7] that number has been steadily and steeply increasing. Additionally, nearly 50% of out-of-pocket expenses was attributable to increasing health insurance premiums, which have increased an average of about 6% annually since 1998.[8] Particularly stressed financially in retirement will be those who are single, who have not worked immediately before reaching normal retirement age, who have less than a high school education, who belong to low-income families, or who are women.[9]

* The Legislature only recently (in 1997 and 1999) passed a guaranteed annual benefit adjustment (GABA) for public retirees (i.e., an automatic COLA). This GABA is currently 1.5% annually after 3 years of retirement.

Investment returns not keeping pace

How do investments for retirement figure into the picture? Baby Boomers seem to have relied mostly on capital gains on housing as a substitute for financial income in retirement. And, Baby Boomers seem to be anticipating higher-than-probable income from employer-sponsored pension plans. Hence, many Baby Boomers have underestimated the importance of personal savings. Of those who have personally invested in the stock market for their retirement years, their long-term yields have only averaged about 8% annually. Moreover, while retirees are relying more and more on income provided through employer-sponsored pension plans, the share of income from public pensions has remained stagnant compared to private pension plans. In other words, over the last three decades, the amount of money paid to retirees through private pension plans has increased, while income to retirees from *public* pension plans as a percentage of salary has virtually flatlined.[10]

Collision at the intersection

Montana's aging population combined with rising health care costs translates into a significant strain on government resources and a potentially explosive political issue for state lawmakers. Making maximum use of available resources, therefore, becomes a critical policy objective.

Last interim: Seeing the tip of the iceberg

Last interim, the Legislature began to see the tip of the iceberg when the Committee on Public Employee Retirement Systems (CPERS) commissioned numerous focus groups across Montana. The focus groups consisted of a large cross section of employees and employers who participate in the largest of Montana's public pension plans, the Public Employees' Retirement System (PERS). A common theme heard by CPERS was concern about the escalating cost of health care insurance and other medical expenses after retirement.

Scope of the problem: Initial examination of the problem as it related to PERS revealed that the issue is significant in its scope:

- Montana's PERS consists of about 500 different public employers (the state, the University System, counties, cities, school districts, and other public agencies), more than 28,000 employees, and over 12,000 retirees. (Taking into account all of the public retirement systems, there are more than 67,000 public employees in Montana and about 23,000 public retirees and benefit recipients.)[11]

- The average benefit payment to a PERS retiree is less than $600 a month.[12]

- State law provides that a person who retires from active service with at least 5 years of service may stay on the employer's group health insurance plan after retirement until the member becomes eligible for Medicare at age 65 or the member joins another group plan with the same or greater benefits at equivalent cost.[13]

- State law also provides that the group plan member who stays on the employer's group health insurance plan pays the full premium for that coverage.[14] (Premiums for the state's group health insurance plan will increase from $270 a month to $295 a month by January 2001.[15] Premiums under some local government plans are approaching $400 a month.[16])

- Although a significant benefit to public retirees, at least under the state plan, is the fact that they are charged the same rate as active employees even though retirees are a higher-risk, higher-cost group. Still, for a retiree, the cost of paying the full premium is significant and increasing.

Initial exploration of options: In response to its findings and based on consultant recommendations, CPERS began to explore options last interim

for helping PERS employees save for postretirement health care costs. Three options discussed were:

- establishing a Voluntary Employees' Beneficiary Association (VEBA) plan outside of PERS as a savings vehicle to pay for eligible health care costs;

- establishing an IRC section 401(h) plan as a separate plan under PERS to be used to pay eligible health care costs after an employee's retirement; and

- requiring the state's IRC section 457 deferred compensation plan provider to offer a postretirement health care plan.

The CPERS's consultants recommended the VEBA and presented a plan that would have diverted 2% of PERS contributions to individual health care expense accounts. However, before this scenario was further discussed, the Department of Administration articulated its concern that IRC regulations governing VEBA plans seemed unclear. Focus then shifted to the 401(h) option. However, although IRS regulations governing 401(h) accounts seemed more defined, the potential for the 401(h) plan to compromise the qualified (tax-exempt) status of PERS became a new concern. The CPERS gave no attention to the third option involving 457 deferred compensation plan vendors. With time during the interim running out, CPERS recommended further study and included the study directive in HB 79 (Ch. 471, L. 1999).

CHAPTER 2:
VEBA AND 401(h) PLANS COMPARED[17]

Picking up from last interim

The 56th Legislature enacted House Bill No. 79 (Chapter 471, Laws of 1999), establishing a new optional Defined Contribution Retirement Plan in PERS and requiring further study of postretirement health care issues. The Legislative Council assigned the study to the State Administration, Public Retirement Systems, and Veterans' Affairs Interim Committee (SAIC), which appointed a subcommittee to pick up where CPERS left off: comparing the features of a VEBA plan and a 401(h) plan.

Common features of VEBA and 401(h) plans

The VEBA and 401(h) plans are both vehicles for financing "employee welfare benefits" and share the following features:

- both allow employer contributions to be made on a tax-free basis, which means the employer pays no employment taxes or benefit contributions on the amounts contributed to the plans;

- both are trust accounts in which assets are managed in a fiduciary manner and invested to accrue tax-free earnings; and

- both pay employee welfare benefits that are not taxable. Welfare benefits may include all medical costs as defined under the IRC section 213(d), including hospitalization, physical examinations, diagnostic procedures, and treatment therapies, as well as supplemental insurance premiums, such as Medicare B premiums or supplemental disability insurance premiums.

Advantages and disadvantages

The VEBA and 401(h) plans each have a different mix of advantages and disadvantages, which are summarized below.

VEBA plans

Advantages	*Disadvantages*
- trustees have flexibility to specify what benefits are paid	- requires a new administrative structure
- available to active and retired employees	- individual employees may not "opt out" of VEBA membership if the employee group joins
- balances may be carried over year to year	- requires IRS qualification (determination letter)
- portable	- will not benefit current retirees
- employee groups may decide whether or not to participate	
- administration is independent of employer or union control	
- contributions to and payments from do not count against pension plan limits	

401(h) plans

Advantages	*Disadvantages*
- administered under an existing board of trustees (i.e., the pension plan board), requiring no new administrative structure	- must be coordinated with pension plan limits
- excess pension plan assets may be used as a funding source	- obligations are subordinate to the pension plan
	- tax qualification issues may jeopardize pension qualification

Figure 1: VEBA and 401(h) Comparison

FEATURES/ISSUES (Similarities/Differences)	VEBA	401(h)
Governance of trust fund (different)	- IRC sections 501(c)(9) and 419 - Applicable state law - Set up as separate trust funds for members of an *employee group* - Administered under its own board of trustees; must be independent from employer control	- IRC section 401(h) - Applicable state law - Set up under and *subordinate to a defined benefit* (DB) pension plan - Administered by the DB plan's board of trustees
Employer contributions and tax advantages (same)	- Employer contributions made pretax (no FICA) - Earnings accrue tax-free - Benefit payments for qualified expenses are not taxable	- Employer contributions made pretax (no FICA) - Earnings accrue tax-free - Benefit payments for qualified expenses are not taxable
Employee contributions (different)	After tax	After tax — *unless* IRS rules that employer "picks up" the contribution under IRC 414(h)
Coordination with pension plan (different)	No	Yes - contributions count against pension plan limits

FEATURES/ISSUES (Similarities/Differences)	VEBA	401(h)
Accounting and investment of funds (similar, but...)	- Individual medical expense accounts - Employees may direct investments among options, such as a defined contribution (DC) plan or 457 deferred comp plan	- Individual medical expense accounts for accounting purposes only - Assets are typically pooled and invested with DB plan assets
Benefits payable (same)	- Expenses related to sickness, accident, and hospitalization and other eligible medical expenses, *including Medicare B premiums and premiums for life or medical insurance* (if premium is not paid for by employer benefit package)	- Expenses related to sickness, accident, and hospitalization and other medical expenses (same as a VEBA)
Who is eligible for benefit payments? (different)	Active employees and/or retirees, spouses, dependents, and beneficiaries	Only retirees and their spouses, dependents, or beneficiaries (not active employees)
Other allowable contributions (different)	Value of unused sick leave or termination pay may be contributed to the VEBA instead of the employee receiving a taxable lump-sum cash-out	Excess DB plan assets may be transferred to the 401(h) account under certain circumstances

CHAPTER 3:
CASE STUDIES

A Washington VEBA plan case study

In 1983, the Association of Washington School Principals, the Washington Association of School Administrators, and the Washington Association of School Business Officials formed a 501(c)(9) VEBA organization. These organizations together appoint six trustees that serve as the VEBA's governing board.

Plan type -- medical expense plan: The VEBA trustees established a trust fund and designed a medical expense plan that provides VEBA members with tax-free reimbursement of any medical expense that is tax-deductible under IRS laws (specifically outlined in IRS Publication 502).

Plan services -- contracted: The VEBA Service Group of Wilkerson & Associates, Inc. in Spokane helped design and implement the plan, maintains two regional offices in Washington to service plan participants, and administers the plan's contracts for services. REHN & Associates Inc. provides benefit administration services. Plan service costs are paid by the trust fund.

The plan is entirely portable, and an employee that belongs to the VEBA continues to have a VEBA account and may be paid benefits from the account even if the employee moves to another employer.

Defined contribution plan: The VEBA medical expense plan is structured as a defined contribution plan with individual member accounts. The plan recently provided that employees may direct investment of their accounts among three fund options: a fixed fund, a stable value fund, and a growth fund. The Dwight Asset Management firm acts as the trust's investment manager.

Participation and funding: Washington state law authorizes voluntary employer participation in the plan. Employees of each governmental entity may "get together" to form an association that "joins" the established VEBA. An employee of a group that chooses to join the VEBA cannot "opt out". If employers of the employee group agree to participate, then the employers fund the plan through a rollover of unused sick leave.

In Washington, state employees, university system employees, and most school district employees are entitled to a 25% "cash-out" of unused sick leave when they terminate employment. Instead of paying a taxable lump-sum cash payment plus benefits, the employer contributes the money tax-free to the VEBA trust account. In some isolated cases, employee bargaining units that joined the VEBA bargained with the employers for a 1% employer contribution to the employees' VEBA trust accounts in lieu of a salary increase. This allowed employers to reduce payroll costs, and the amount was not taxable income to the employees.

Initially, the VEBA medical expense plan covered only certain school districts that chose to participate at the start. Today, 220 out of 296 school districts in Washington participate. In 1993 (10 years after the VEBA's start), the Washington Legislature decided to provide for state agency participation in a VEBA, but chose to establish the state plan separate from the already-established school district plan.

The original state plan failed to meet IRS qualification standards, received an unfavorable determination letter, and was dropped. In September of 1999, the Washington Legislature finally approved legislation authorizing state agencies to participate in the already-established school district VEBA and has already found the VEBA to be very popular among state employees. More than 11,000 active employees currently participate in the plan; and, since 1983, benefits have been paid to more than 20,000 participants.[18]

The Polson School District plan

In 1999, the Montana Public Employees' Association chapter at the Polson School District negotiated with and secured the participation of the school district in a postretirement health care benefit program established by Nationwide Retirement Solutions. Under the agreement, school district employees receive a monthly employer contribution to individual accounts set up for the employees as part of the Nationwide Post Employment Health Plan (PEHP). The PEHP is a "turnkey" VEBA plan providing members with reimbursements for qualified health care expenses.

Nationwide provides a separate trust arrangement for collective bargaining plans and noncollective bargaining plans.

PEHP members may invest their accounts in funds offered under the PEHP Group Variable Annuity Contract, which consists of nine investment choices: five life style asset allocation portfolios, a very high-risk fund, a high-risk fund, a moderate-risk fund, and a stable value fund. Employee accounts are assessed an annualized administrative fee.[19]

A 401(h) case study

The actuarial benefits consulting firm of Gabriel, Roeder, Smith & Company (GRS) recently published a company Benefits Research Report that examined 401(h), general asset, and VEBA accounts. As a case study of a 401(h) account, the report described how a public employer, who had been paying retiree health care benefits on a pay-as-you-go basis from the general fund, commissioned GRS to conduct an actuarial study of liabilities and to make recommendations for helping the public employer begin to prefund these benefits.

The GRS study found, not surprisingly, that the pay-as-you-go approach would soon present costs beyond the reasonable means of the employer. The study also found that the pension trust fund experience had been

favorable enough in recent years to provide a funding source for retiree health care benefits. The GRS helped the plan sponsor to design and implement, under IRC 401(h), a defined postretirement health benefit plan for retirees. Excess pension funds were transferred to the 401(h) account and used to actuarially fund postretirement health care benefits. This allowed contributions to be invested, and contributions plus investment income were used to pay retiree health benefits. Unfunded liabilities in the pension plan and 401(h) plan could then be amortized over a reasonable (actuarially sound) time horizon instead of retiree health benefits being paid on a pay-as-you-go basis from the general fund.[20]

In summary

The Washington and Polson VEBA plans and the GRS case study of a 401(h) plan each demonstrate a different approach to financing public employee and retiree medical benefits. Yet, each model provides tax-free contributions, investment earnings, and health care benefits.

The Subcommittee on Disability and Retiree Health Care determined that the best approach for Montana was to provide for a VEBA plan, which would be centrally administered by the Department of Administration through contracted services. Appendix B identifies the decisions made by the Subcommittee based on an issues and options checklists. LC 198, which is outlined in the Executive Summary, implements the Subcommittee's recommendations.

ENDNOTES

1. "Lawmakers Brace for Tidal Wave of Aging Baby Boomers," Western Legislatures, September/October 1997.

2. Ibid.

3. United States Congress, "Baby Boomers in Retirement: An Early Perspective," Congressional Budget Office, September 1993.

4. Ibid.

5. National Coalition of Health Care, "Health Care Costs Threaten Middle Class", http://www.nchc.org/middle.html, February 2000, citing a study by the Henry J. Kaiser Family Foundation.

6. United States Congress, *Baby Boomers in Retirement: An Early Perspective*, Congressional Budget Office, September 1993.

7. Ibid.

8. The Kaiser Family Foundation and Health Research and Educational Trust, *Employer Health Benefits: 1999 Survey.*

9. United States Congress, *Baby Boomers in Retirement: An Early Perspective*, Congressional Budget Office, September 1993.

10. Ibid.

11. Public Employees' Retirement Board and Teachers' Retirement Board financial reports.

12. Ibid.

13. Section 2-18-704, MCA.

14. Ibid.

15. Section 2-18-703, MCA.

16. Telephone interviews with various local government human resource officers.

17. Source materials for VEBA and 401(h) information:

    Title 26 of the United States Code, Sections 401and 501

    Employee Benefit Research Institute, *Issue Brief*, No. 112, "Retiree Health Benefits: Issues of Structure, Financing, and Coverage," March 1991.

    Gabriel, Roeder, Smith & Company, *Benefits Research Report,* No. 1999-1, "Funding Vehicles for Retiree Health Care", April 1999.

    Mary Beth Braitman and Terry Mumford, *A Federal Law Perspective on Financing Post-Retirement Health Plans: Briefing Materials for the State Administration, Public Retirement, and Veterans' Affairs Interim Committee, 56th Legislature,* Ice Miller Donadio & Ryan, June 21, 2000.

    Mary Beth Braitman and Terry Mumford, *Briefing Paper on Payment of Health Care Benefits, Including: 401(h) Accounts, 125 Plans, VEBA Trusts and Separate Trusts,* Ice Miller Donadio & Ryan, June 21, 2000.

18. The Washington Public Employees Association website at www.wpea.org/veba.htm and interviews with Mr. Mark Wilkerson, Wilkerson & Associates, Inc., VEBA Services Group, 4005 Jefferson, Suite 301, Spokane, WA, 99204, (509) 838-5571.

19. Nationwide Retirement Solutions, *Post Employment Health Plan (PHEP),* brochure, Two Nationwide Plaza, 2-17-04, P.O. Box 16747, Columbus, OH 43216; and interviews with Mr. Tim Crossin of Nationwide and Ms. Sandy Dennison, President of the MPEA chapter at the Polson School District.

20. Gabriel, Roeder, Smith & Company, *Benefits Research Report,* No. 1999-1, "Funding Vehicles for Retiree Health Care", April 1999.

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APPENDIX A
MEETING DATES AND MAJOR AGENDA ITEMS

The following is a list of the meeting dates during which either the full SAIC or its Subcommittee on Disability and Retiree Health Care discussed and acted on various aspects of the retiree health care issue. This list is provided to aid readers interested in researching the meeting minutes and exhibits, which are available by contacting the Montana Legislative Services Division, P.O. Box 201706, Room 110, State Capitol, Helena, Montana, 59620-1706, (406) 444-3064, or on the Internet at http://www.leg.state.mt.us.

February 29, 2000:	*Subcommittee on Disability and Retiree Health Care:* Staff Research Paper #1: Background research on retiree health care issues
March 31, 2000:	*Subcommittee on Disability and Retiree Health Care:* Staff Paper #2 and PowerPoint Presentation: Overview of retiree health care financing vehicles and options for moving forward
June 21, 2000:	*Full SAIC:* Presentations by Nationwide Retirement Solutions and VEBA Services Group, Inc.; consultants' report; round-table discussion; preliminary recommendations
August 4, 2000:	*Subcommittee on Disability and Retiree Health Care:* Review of initial bill draft
September 14, 2000:	*Subcommittee on Disability and Retiree Health Care:* Issues and options checklist: final actions
September 15, 2000:	*Full SAIC:* Receipt of Subcommittee report: adoption of recommended legislation (LC 198) based on the issues and options checklist decisions

APPENDIX B
ISSUES AND OPTIONS CHECKLIST

Reflecting decisions made by the
Subcommittee on Disability and Retiree Health Care
September 14, 2000

PART I
GOVERNANCE, SCOPE, ADMINISTRATION, AND MEMBERSHIP

ISSUE 1: **Governance. How should the "Voluntary Employees' Beneficiary Association", or VEBA, (a 501(c)(9) qualified trust organization) be established?**

Options:

A. ____ Decentralized, thus allowing each public employer to establish its own VEBA program.

B. __X_ Centralized, thus establishing one statewide VEBA and making provisions about whether and how state and local governments participate. Optional for local employers.

1. ____ The Legislature should create a new independent board that would act as the VEBA board of trustees under IRC 501(c)(9).

2. __X_ The Legislature should designate a program administrator, which would then be *required* to contract with an already-established 501(c)(9) organization (such as the Nationwide Retirement Solutions PEHP, or the Spokane-based VEBA Services Group, Inc.).

3. ____ The Legislature should designate an already-existing independent board to be the VEBA board of trustees.

(a) ____ The board *may* contract for administration of the program.

(b) ____ The board *shall* contract for administration of the program.

Notes: Ice Miller's June 15, 2000, paper prepared for SAIC staff stated that, to qualify for tax-exempt status under IRC 501(c)(9),"there must be an entity, such

as a corporation or trust, which is separate and distinct from the member-employees or their employer. This distinct entity must be controlled by (1) its members, (2) an independent trustee such as a bank, or (3) trustees or other fiduciaries, at least some of whom are designated by member-employees. An organization will be considered to be controlled by independent trustees if it is an "employee welfare benefit plan". . . which is "a plan or fund maintained for the purpose of providing for its participants or their beneficiaries welfare benefits, which include medical benefits."

The consultant recommended a centralized approach. A centralized program would provide a consistent approach and one centralized point for contracting for the services required to administer accounts and manage investments. Under a centralized approach, various options exist about how a central VEBA organization would be incorporated as a 501(c)(9) entity and how local employers and employees could "opt in". (See Issue 4.) Because nothing prohibits the Polson School District, for example, from contracting for the Nationwide PEHP program or from making other collectively bargained arrangements, the centralized approach would not necessarily preclude continuation of this practice, unless specific prohibitions were placed in state law.

ISSUE 2: **Scope. Who should the program encompass?**

Options:

A. ____ Only state employees

B. ____ Only PERS members

C. ____ Members of certain retirement plans (please specify which plans, or all plans)

D. __X_ All public employees

ISSUE 3: **Program administration. Based on decisions under Issues 1 and 2 above, who should be the program administrator?**

Options:

A. ____ PER Board

B. __X_ Department of Administration

C. ____ Each retirement system's administrative board

D. ____ Each public employer

E. ____ Other, please specify

ISSUE 4: Membership determination.

A. How should employer participation be determined?

Options:

1. ____ Each employer should decide whether or not to participate in the VEBA program. Employers would have the right to "opt in" or "opt out" at anytime, with the understanding that employees with VEBA accounts would continue to have access to those accounts until they have exhausted their account balances.

2. __X_ Employees should vote on whether or not the employer participates (i.e., employees should be allowed to request an election and the outcome of the election would determine whether the employer would participate in a VEBA program).

   (a) How many employees should be required to trigger an employer election?

      (i) ____ a set number of employees (e.g., 10) should have to initiate the request for an election

      (ii) __X_ a certain percentage of employees should request an election (e.g., 25% of the employing agency's employees) _25%__ specify percentage before the employer would hold an election

      (iii) ____ a number ____ and a percentage ____ , which ever is less, should be required to initiate a request before an election would be held

   (b) What number must vote "yes" in order to require employer participation?

      (i) __X_ a simple majority

      (ii) ____ a supermajority (e.g., two-thirds or three-fourths), please specify

B. How should employee participation be determined?

Options:

1. ____ Participation should be by employer, so that if an employer participates, all employees of that employer participate.

2. __X_ Employees should form "an association" (could be a collective bargaining unit or some other affiliation or an affiliation only for the purposes of VEBA participation) and if the majority of employees in that association want to participate, then all in that group must participate (essentially, a collectively bargained arrangement).

3. ____ Each employee of a participating employer should be allowed to individually decide whether or not to participate. For example, if an employee elects to participate, then all sick leave hours over a certain threshold (depending on decisions under Part II - Funding) would be mandatorily "converted" to VEBA contributions and the employee would no longer be able to receive an accrual of sick leave hours, either for a cash-out or for taking as actual sick leave hours.

**IRS Note:* *In no case could employees be given the option to either receive sick leave cash or to deposit that same money to a VEBA account instead. Although employees may elect to join or not to join a VEBA and have sick leave converted to VEBA contributions, that election is a one-time irrevocable election to be made "prospectively", i.e., before the fact. (However, if the SAIC seriously desires to find a way to give employees more than one point in time to make an election about whether to convert sick leave to a VEBA contribution, such as a once-a-year election, then creative language would need to be crafted and an IRS determination letter would likely be required.)*

PART II
FUNDING

ISSUE 5: **Funding with unused sick leave.**

A. What amount of sick leave should be carried as a *minimum balance* before contributions to the health care expense trust account are made in lieu of sick leave?

Options:

1. ____ none
2. ____ 60 hours (7.5 days)
3. ____ 480 hours (60 days)
4. __X_ other, please specify __120 hours_(3 weeks)___

Notes: Under the state's sick leave pool program, which is voluntary and not required by state statute, an employee must carry at least 40 hours of sick leave as a balance after a donation to the sick leave pool or direct grant program. Also, an employee may not donate more than 40 hours in a 12-month period. Finally, not all teachers accrue sick leave. Also, the number of sick leave days that a teacher is allowed to accrue may be limited by a collective bargaining agreement.

See also, section 2-18-601, MCA: This section defines "employee" for the purposes of the sick leave provisions. Elected officials, school teachers, and contract personnel do not accrue sick leave under the provisions in statute that cover all other public employees of "agencies" (i.e., employees of "any legally constituted department, board, or commission of state, county, or city government or any political subdivision thereof").

B. What "cash-out" amount should be credited for the unused sick leave and contributed to the health care expense trust account in lieu of the sick leave cash-out?

Options:

1. __X_ 25%, as provided for now in current law
2. ____ 50%
3. ____ 75%
4. ____ 100%
5. ____ other, please specify

C. _X_ **Limits.** To moderate financial impact on employers, there should be a limit on the number of accrued sick leave hours that can be "converted" to a VEBA account contribution in 1 year or at one time, based on rules to be adopted by the Department of Administration.

Notes: Any increase above the 25% will offer an incentive for employees to participate in the VEBA. However, any increase in the percentage will also increase employer costs.

Currently, the value of that 25% cash-out of an employee's unused sick leave may be rolled into the employee's retirement plan (except for the University System's Optional Retirement Plan). Thus, while a cash-out would be taxed, the rollover to a retirement account is not taxed (at least until it is "constructively" received as pension income). If the VEBA were to increase the percentage of the unused sick leave that was available as a contribution to the VEBA, an additional incentive would be created to participate in the VEBA rather than to roll over that amount into the employee's retirement plan.)

ISSUE 6: **Timing of contributions. For employees participating in the VEBA program, how often should accrued sick leave credit be contributed to the employee's VEBA account?**

Options:

A. ____ only as often as a "cash-out" is currently allowed for by law (e.g., at termination of employment, excluding transfer between agencies under the same jurisdiction)

B. __X_ each pay period, which is when sick leave is credited; choice of how much to convert each pay period would be made once a year

C. ____ annually

D. ____ let the program administrator decide by rule

E. ____ as often as requested by the employee (cannot be more often than each pay period)

Notes: Administration and finances are key considerations in deciding how often sick leave should be converted. Also, there needs to be further clarification about IRS "don'ts" and what happens to accrued sick leave before it is converted to the VEBA contribution. Can an employee who has elected to participate in the VEBA take accrued hours as regular sick leave in the meantime? Current law, Section 2-18-618, MCA, does not allow employees to take their 25% cash out until they terminate employment with the employer. Making contributions to a VEBA more often than that occurrence will increase employer costs. Also, it is likely that employer costs will increase because more employees will save rather than use their sick leave hours. The decision under Option 5A above will also affect costs

to the extent that employees must accrue a certain minimum balance before "converting" sick leave hours.

ISSUE 7: **Unused vacation leave. Should contributions in lieu of a "cash-out" for unused vacation leave also be used as a funding source?**

Options

A. _X_ No.

B. ___ Yes.

(1) ____ and should be used in the same manner, under the same parameters, as the use of unused sick leave

(2) ___ and . . . (please specify particulars as addressed for sick leave)

Notes: Section 2-18-611, MCA, currently allows permanent full-time "employees" (as defined in section 2-18-601, MCA, and that does NOT include elected officials, teachers, or independent contractors) to accrue annual vacation leave credits. Vacation leave is credited at the end of each pay period. Section 2-18-617, MCA, places a maximum on accrual of vacation leave and requires employees to use it within 90 days after the end of the year in which they accrued the leave, or they lose it. A school district is not prohibited from providing cash compensation for unused sick leave through policy or a collective bargaining agreement.

ISSUE 8: **Termination pay. Should contributions in lieu of termination pay also be used as a funding source?**

Options

A. _X_ No.

B. ___ Yes.

Notes: Like sick leave, termination pay may be rolled over into an employee's retirement plan (except for the University System's Optional Retirement Plan). There is no statutory provision stating that employers (state or local) must provide for termination pay. However, it is likely that collective bargaining agreements or other employer policies may make provision for termination pay. Presumably, employer policies and collective bargaining agreements could also include a contribution to a VEBA plan in lieu of the termination pay. However, IRS issues would need to be further clarified with Ice Miller if the Subcommittee were interested in pursuing Option 8B.

PART III
POOLED SICK LEAVE PROGRAM

ISSUE 9: **Pooled sick leave program. Should the Legislature provide for a NEW pooled sick leave program for employees participating in the VEBA program?**

Options:

A. __X_ No.

1. ____ Leave current laws on sick leave pool unchanged. (The Department of Administration has implemented a voluntary sick leave pool and direct grant program for "employees" as defined in section 2-18-601, MCA, which excludes state and local elected officials, teachers, and contracted employees. Section 2-18-618(10), MCA, allows local governments to establish and administer their own pooled sick leave funds.)

2. ____ but clarify that only *non-VEBA* members participate in programs currently provided for

3. _X_ but clarify that *any* state employee (regardless of whether the employee is a VEBA member) may participate in programs currently provided for

B. ____ Yes, a new pooled sick leave program for VEBA participants should be established.

1. Program participation:

(a) ___ mandatory

(b) ____ voluntary

(c) ____ determined by the program administrator through rules

2. Program design:

(a) ____ determined by the program administrator

(b) ____ determined by each employer

(c) ____ specified in state statute

Notes: The current sick leave program for STATE AGENCY employees is a voluntary program provided for in Department of Administration rules. If a new or alternative program were contemplated, the VEBA bill could include provisions requiring employers participating in the VEBA to establish a sick leave pool, either mandatory or voluntary. The program specifics could be outlined in the legislation, or the legislation could allow each employer to design its own program. If no change from current policy and practice is provided for in the bill, then consideration should be given to the impact that a VEBA program would have on current programs. For state agencies, the voluntary program would likely see even less participation. Additionally, consideration should be made about whether VEBA members (i.e., employees who will be having sick leave converted to VEBA account contributions) should retain the same rights as non-VEBA participants in regard to access to the state sick leave pool or eligibility for a direct sick leave grant.

PART IV
INVESTMENT AND USE OF ACCOUNTS

ISSUE 10: **Type of VEBA program. Should the health care expense trust account program be a Defined Contribution or Defined Benefit Plan?**

Options:

A. _X_ A Defined Contribution plan, where contributions are specified amounts made to each employee's individual account

B. ____ A Defined Benefit plan, where contributions are made to a pooled trust fund to provide specified benefits to members

ISSUE 11: **Investment fund management. How should fund management services be obtained?**

Options:

A. __X_ Through contracted services

B. ____ By the Montana Board of Investments

C. ____ Let the VEBA board of trustees decide

ISSUE 12: **Investment choices. Assuming selection of Option 10A for a Defined Contribution Plan, how many investment choices should employees be offered?**

Options:

A. ____ a minimum of ___

__ and __or

B. ____ a maximum of ___

C. ____ Let the VEBA board of trustees decide

D. __X__ Department of Administration would decide

Notes: There will be 16 investment options offered in the new PERS DC retirement plan; 28 options are provided in the state's deferred compensation (457) plan; there are 8 options provided in the TIAA-CREF Optional Retirement Plan for the University System. Use of the VEBA accounts for immediate medical or health care needs will likely require an investment strategy that is different

than investment strategies for longer-term retirement investments. However, employees will have different needs, different expectations, and different tolerance for risk, which requires some consideration about how the investment program should be structured and what types of investment vehicles should be used.

ISSUE 13: Use of accounts.

A. Should the use of the health care expense trust accounts be restricted to certain expenses or should all expenses that meet the definition of a "qualified health care expense" under 26 U.S.C. 213(d) be allowed?

Options:

1. ____ use of VEBA accounts should be restricted to the following expenses (please specify):

2. __X_ all "qualified health care expenses" under the IRS Code should be allowable

3. ____ let the VEBA board of trustees decide

B. When should VEBA members be allowed to access their accounts (but, in any case, only for qualified health care expenses)?

Options:

1. __X_ any time (whether actively employed or retired)

2. ____ only upon becoming a vested member of a retirement plan

3. ____ only after retirement

4. ____ let the VEBA board of trustees decide

5. ____ other, please specify

C. How should beneficiaries be dealt with in the bill?

Options:

1. ____ not addressed (which would mean that the VEBA account may be forfeited at death)

2. __X_ a death benefit should be "spelled out" in the bill draft

3. ____ a death benefit should be provided for in the bill, but "spelled out" in rules adopted by the program administrator

Consultant notes: Ice Miller specifically recommended that the bill provide for a death benefit so that the VEBA accounts would not be forfeited at death.

PART V
ENFORCEMENT

ISSUE 14: **Penalty. Should the bill provide for any type of penalty for fraudulent claims?**

Options:

A. __X_ No, so that whatever existing criminal laws would apply are applicable.

B. ____ Yes.

(1) ____ Criminal penalty

(a) ____ expressly stated in a new section in the bill

(b) ____ through reference to another criminal penalty in other MCA section (please specify)

(2) ____ Civil penalty (monetary fine only) -- must be expressly stated in a new section in the bill

Notes: If Option 14A is selected, the effect would be that other statutes would have to be used if the program administrator needed to pursue action against someone for making false claims. To the extent that the other statutes are relevant to the situation, then they would apply. If not relevant, they would not apply. (See sections 45-7-203, 45-7-208, and 45-7-210, MCA, which are the general penalties that may or may not apply to fraudulent claims.) Claims could not be paid for expenses that were not "qualified health expenses" under the plan.

PART VI
IMPLEMENTATION

ISSUE 15: **IRS qualification and effective date(s). How should program IRS qualification be handled?**

Options:

A. _X_ The program should not be effective *unless or until* a favorable IRS determination letter is received.

1. __X_ The program administrator should be required to request an IRS ruling. The administrator certifies a positive determination, which triggers the program's effective date.

NOTE: Consideration must be made of the startup time involved. An IRS ruling may or may not coincide with completion of implementation tasks.

ISSUE 16: **Start-up costs. How should startup costs be paid?**

Options:

A. _X_ The Department of Administration will front the costs, which will eventually be paid from administrative fees assessed on the VEBA plan.

B. ____ Direct appropriation (please specify)

C. ____ Other (please specify)

APPENDIX C

INITIAL DRAFT OF LC 198

The latest version of LC 198 will be available
by accessing the Legislative Branch LAWS bill status system at
http://www.leg.state.mt.us

LC 198 will receive a bill number when it has
been introduced for the 2001 Session

_____ BILL NO. _____

INTRODUCED BY _____
(Primary Sponsor)

BY REQUEST OF THE STATE ADMINISTRATION, PUBLIC RETIREMENT SYSTEMS, AND VETERANS' AFFAIRS INTERIM COMMITTEE

A BILL FOR AN ACT ENTITLED: "AN ACT REQUIRING THE DEPARTMENT OF ADMINISTRATION TO ESTABLISH AN EMPLOYEE WELFARE BENEFIT PLAN CONSISTING OF INDIVIDUAL HEALTH CARE EXPENSE TRUST ACCOUNTS FOR PUBLIC EMPLOYEES; PROVIDING FOR PROGRAM ADMINISTRATION; PROVIDING THAT CONVERSION OF UNUSED SICK LEAVE TO EMPLOYER CONTRIBUTIONS TO THE PLAN MAY BE USED AS A FUNDING SOURCE; PROVIDING A TAX EXEMPTION FOR CONTRIBUTIONS, EARNINGS, AND PAYMENTS; PROVIDING DEATH BENEFITS; REQUIRING THAT THE BENEFIT PLAN BE SUBMITTED TO THE COMMISSIONER OF INTERNAL REVENUE FOR A PRIVATE LETTER RULING TO ENSURE THAT THE PLAN IS FEDERALLY TAX-QUALIFIED; AUTHORIZING A LOAN FROM THE BOARD OF INVESTMENTS; AMENDING SECTIONS 2-18-618 AND 15-30-111, MCA; AND PROVIDING EFFECTIVE DATES."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MONTANA:

NEW SECTION. **Section 1. Short title.** [Sections 1 through 10] may be cited as the "Voluntary Employees' Beneficiary Association Act".

NEW SECTION. **Section 2. Purpose and intent.** The legislature finds that escalating health care expenses, particularly the increasing cost of medical treatment and health insurance, constitute a substantial financial burden during and after an employee's working career. The purpose of [sections 1 through 10] is to provide a means by which public employers may contribute to a plan established under a qualified tax-exempt trust organization to assist public employees, their dependents, and their beneficiaries with paying for qualified health care expenses. Under the plan, employer contributions, investment earnings, and payments for qualified health care expenses are tax-exempt. The legislature also finds that centralized statewide administration offers a consistent approach and is more cost-effective,

especially for smaller employers. However, the legislature does not intend to prohibit an employer from establishing a similar program as an alternative or in addition to participation in the statewide program provided for in [sections 1 through 10]. Additionally, the legislature intends to facilitate a grassroots process to determine plan participation.

NEW SECTION. **Section 3. Definitions.** As used in [sections 1 through 10], unless the context requires otherwise, the following definitions apply:

(1) "Common association" means an association of employees established pursuant to [section 7] for the purposes of employer and employee participation in the plan.

(2) "Contracting employer" means an employer who, pursuant to [section 7], has contracted with the department to participate in the plan.

(3) "Department" means the department of administration established in 2-15-1001.

(4) "Employee" means a person employed by an employer but does not include an independent contractor or person hired by the employer under a personal services contract.

(5) "Employer" means a legally constituted department, board, or commission of the state, a county, an incorporated city or town, or any political subdivision of the state, including a school district or a unit of the university system.

(6) "Health care expense trust account" or "account" means an account established for the payment of qualified health care expenses under the plan.

(7) "Member" means an employee who belongs to a voluntary employees' beneficiary association established under [section 7].

(8) "Plan" means the employee welfare benefit plan established under Internal Revenue Code section 501(c)(9) pursuant to [section 4].

(9) "Qualified health care expenses" means expenses paid by a member for medical care, as defined by 26 U.S.C. 213(d), for the member or the member's dependent as defined by 26 U.S.C. 152.

NEW SECTION. **Section 4. Statewide employee welfare benefit plan established -- health care expense trust accounts -- investment of funds -- account access -- administrative expenses.** (1) The department shall establish, through contracted services, a plan under a tax-exempt entity that qualifies as a voluntary employees' beneficiary association trust pursuant to section 501(c)(9), of the Internal Revenue

Code, 26 U.S.C. 501(c)(9). The plan must provide members with individual health care expense trust accounts to pay the qualified health care expenses of members, their dependents, and their beneficiaries.

(2) The department shall determine what investment vehicles will be offered to plan members. Each plan member is entitled to direct the investment of funds in the member's account among the investment vehicles offered. The department shall provide for a default investment vehicle if a member fails to direct how funds are to be invested.

(3) At any time after a member's account has been established, the member may access funds in the account in a manner prescribed by the department. The funds may be accessed only for the payment of qualified health care expenses and until the funds have been exhausted.

(4) Administrative expenses must be paid by the plan in a manner prescribed by the department.

NEW SECTION. **Section 5. Rulemaking authority.** The department shall adopt rules to implement the provisions of [sections 1 through 10]. The rules must be designed to allow the plan to conform to federal law.

NEW SECTION. **Section 6. Administration of plan -- content of plan document.** (1) The department shall provide for the administration of the plan in the manner required to satisfy applicable tax qualification requirements of the Internal Revenue Code.

(2) For purposes of qualification pursuant to section 501(c)(9) of the Internal Revenue Code, 26 U.S.C. 501(c)(9), and any other applicable internal revenue service laws and regulations, the plan document is composed of [sections 1 through 10] and the rules adopted by the department to implement [sections 1 through 10].

NEW SECTION. **Section 7. Plan membership election -- contract for employer participation.** (1) At the request of at least 25% of its employees, an employer shall facilitate an election by all the employer's employees or by a specified group of the employer's employees to determine whether those employees will form an association for the purpose of participating in the plan.

(2) If a majority of the employees voting on the question vote to become plan members, then, in a manner prescribed by the department:

(a) all of the employees that were eligible to vote on the question must be formed as a common

association for the purpose of plan membership and the employees must become plan members; and

(b) the employer shall enter into a contract with the department to participate in the plan and must become a contracting employer.

(3) A common association shall operate in a manner prescribed by the department unless the association is disbanded in a manner prescribed by the department.

(4) A contracting employer shall provide to the department, or the appropriate administering entity, the information necessary for the plan's operation. The department, in partnership with a contracting employer, shall provide to plan members the information necessary to actively participate in the plan.

NEW SECTION. **Section 8. Contributions of unused sick leave -- other contributions not prohibited.** (1) In a manner prescribed by the department, a contracting employer shall provide for a plan member to annually designate how many hours, if any, of the member's unused sick leave that accrued during the previous 12 months will be automatically converted to an employer contribution to the member's account each pay period. However, a member may convert only the unused sick leave hours accrued in excess of 120 hours and no more than the maximum prescribed according to department rule. The amount of the employer contribution to a member's account for hours converted under this subsection must be equal to one-fourth of the pay attributed to the accumulated sick leave. The attributable pay must be computed on the basis of the employee's salary or wage at the time that the sick leave is converted. A member may not later receive as sick leave credit or as a lump-sum payment amounts contributed to the member's account pursuant to this subsection. However, a member is still entitled to the lump-sum payment for unused and unconverted sick leave payable under 2-18-618(6).

(2) This section does not prohibit an employer from entering into an agreement with a member for employer contributions to a member account in addition to the contributions provided for under subsection (1).

NEW SECTION. **Section 9. Tax exemption.** Employer contributions into an account, the accumulation of interest or other earnings in an account, and payments from an account for qualified health care expenses are tax-exempt, as provided in 15-30-111 and under applicable federal laws and regulations to the extent that the plan is qualified under applicable sections of the Internal Revenue Code.

NEW SECTION. **Section 10. Beneficiaries -- death benefits.** (1) A member may designate as a beneficiary any individual, charitable organization, or trust for the benefit of an individual. The designation must be in a manner prescribed by the department.

(2) Upon proof of a member's death, if the deceased member's account retains funds, the member's designated beneficiary is entitled to use the account for qualified health care expenses or to receive a taxable lump-sum payment of the deceased member's account balance. If there is no designated beneficiary or surviving designated beneficiary, the member's personal representative, as defined in 72-1-103, is entitled to a taxable lump-sum payment for disposition as part of the member's estate.

(3) If a payment under this section is payable to a minor, the payment must be made to one of the following in the listed order of preference:

(a) a surviving parent;

(b) a parent awarded custody of the minor in a dissolution of marriage proceeding;

(c) a custodian designated under Title 72, chapter 26;

(d) a guardian appointed pursuant to Title 72, chapter 5, part 2; or

(e) a conservator appointed pursuant to Title 72, chapter 5, part 4.

(4) Payment under this section fully discharges obligations of the plan, the plan's board of trustees, and the department to the deceased member and the member's beneficiaries.

(5) If a person is convicted of knowingly or purposely causing a member's death or disability, that person may not receive payments from the plan and any payments due must be made as otherwise provided by law.

Section 11. Section 2-18-618, MCA, is amended to read:

"2-18-618. Sick leave. (1) A permanent full-time employee earns sick leave credits from the first day of employment. For calculating sick leave credits, 2,080 hours (52 weeks x 40 hours) equals 1 year. Sick leave credits must be credited at the end of each pay period. Sick leave credits are earned at the rate of 12 working days for each year of service without restriction as to the number of working days that may be accumulated. Employees are not entitled to be paid sick leave until they have been continuously employed 90 days.

(2) An employee may not accrue sick leave credits while in a leave-without-pay status.

(3) Permanent part-time employees are entitled to prorated leave benefits if they have worked the

qualifying period.

(4) Full-time temporary and seasonal employees are entitled to sick leave benefits provided they work the qualifying period.

(5) A short-term worker may not earn sick leave credits.

(6) ~~An~~ Except as otherwise provided in [section 8], an employee who terminates employment with the agency is entitled to a lump-sum payment equal to one-fourth of the pay attributed to the accumulated sick leave. The pay attributed to the accumulated sick leave must be computed on the basis of the employee's salary or wage at the time the employee terminates employment with the state, county, or city. Accrual of sick leave credits for calculating the lump-sum payment provided for in this subsection begins July 1, 1971. The payment is the responsibility of the agency in which the sick leave accrues. However, an employee does not forfeit any sick leave rights or benefits accrued prior to July 1, 1971. However, when an employee transfers between agencies within the same jurisdiction, the employee is not entitled to a lump-sum payment. In a transfer between agencies, the receiving agency shall assume the liability for the accrued sick leave credits earned after July 1, 1971, and transferred with the employee.

(7) An employee who receives a lump-sum payment pursuant to this section or who, pursuant to [section 8], converts unused sick leave to employer contributions to a health care expense trust account and who is again employed by any agency may not be credited with sick leave for which the employee has previously been compensated or for which the employee has received an employer contribution to the health care expense trust account.

(8) Abuse of sick leave is cause for dismissal and forfeiture of the lump-sum payments provided for in this section.

(9) An employee of a state agency may contribute any portion of the employee's accumulated sick leave to a nonrefundable sick leave fund for state employees and becomes eligible to draw upon the fund if an extensive illness or accident exhausts the employee's accumulated sick leave, irrespective of the employee's membership or nonmembership in the employee welfare benefit plan established pursuant to [section 4]. The department of administration shall, in consultation with the state employee group benefits advisory council, provided for in 2-15-1016, administer the sick leave fund and adopt rules to implement this subsection.

(10) A local government may establish and administer through local rule a sick leave fund into which its employees may contribute a portion of their accumulated sick leave."

Section 12. Section 15-30-111, MCA, is amended to read:

"**15-30-111. Adjusted gross income.** (1) Adjusted gross income is the taxpayer's federal income tax adjusted gross income as defined in section 62 of the Internal Revenue Code of 1954, 26 U.S.C. 62, as that section may be labeled or amended, and in addition includes the following:

(a) (i) interest received on obligations of another state or territory or county, municipality, district, or other political subdivision of another state, except to the extent that the interest is exempt from taxation by Montana under federal law;

(ii) exempt-interest dividends as defined in section 852(b)(5) of the Internal Revenue Code of 1986, 26 U.S.C. 852(b)(5), as that section may be amended or renumbered, that are attributable to the interest referred to in subsection (1)(a)(i);

(b) refunds received of federal income tax, to the extent that the deduction of the tax resulted in a reduction of Montana income tax liability;

(c) that portion of a shareholder's income under subchapter S. of Chapter 1 of the Internal Revenue Code of 1954 that has been reduced by any federal taxes paid by the subchapter S. corporation on the income;

(d) depreciation or amortization taken on a title plant as defined in 33-25-105(15);

(e) the recovery during the tax year of an amount deducted in any prior tax year to the extent that the amount recovered reduced the taxpayer's Montana income tax in the year deducted; and

(f) if the state taxable distribution of an estate or trust is greater than the federal taxable distribution of the same estate or trust, the difference between the state taxable distribution and the federal taxable distribution of the same estate or trust for the same tax period.

(2) Notwithstanding the provisions of the federal Internal Revenue Code of 1954, as labeled or amended, adjusted gross income does not include the following, which are exempt from taxation under this chapter:

(a) (i) all interest income from obligations of the United States government, the state of Montana, a county, municipality, or district, or other political subdivision of the state and any other interest income that is exempt from taxation by Montana under federal law;

(ii) exempt-interest dividends as defined in section 852(b)(5) of the Internal Revenue Code of 1986, 26 U.S.C. 852(b)(5), as that section may be amended or renumbered, that are attributable to the interest

referred to in subsection (2)(a)(i);

(b) interest income earned by a taxpayer who is 65 years of age or older in a tax year up to and including $800 for a taxpayer filing a separate return and $1,600 for each joint return;

(c) (i) except as provided in subsection (2)(c)(ii), the first $3,600 of all pension and annuity income received as defined in 15-30-101;

(ii) for pension and annuity income described under subsection (2)(c)(i), as follows:

(A) each taxpayer filing singly, head of household, or married filing separately shall reduce the total amount of the exclusion provided in subsection (2)(c)(i) by $2 for every $1 of federal adjusted gross income in excess of $30,000 as shown on the taxpayer's return;

(B) in the case of married taxpayers filing jointly, if both taxpayers are receiving pension or annuity income or if only one taxpayer is receiving pension or annuity income, the exclusion claimed as provided in subsection (2)(c)(i) must be reduced by $2 for every $1 of federal adjusted gross income in excess of $30,000 as shown on their joint return;

(d) all Montana income tax refunds or tax refund credits;

(e) gain required to be recognized by a liquidating corporation under 15-31-113(1)(a)(ii);

(f) all tips or gratuities that are covered by section 3402(k) or service charges that are covered by section 3401 of the Internal Revenue Code of 1954, 26 U.S.C. 3402(k) or 3401, as amended and applicable on January 1, 1983, received by persons for services rendered by them to patrons of premises licensed to provide food, beverage, or lodging;

(g) all benefits received under the workers' compensation laws;

(h) all health insurance premiums paid by an employer for an employee if attributed as income to the employee under federal law;

(i) all money received because of a settlement agreement or judgment in a lawsuit brought against a manufacturer or distributor of "agent orange" for damages resulting from exposure to "agent orange";

(j) principal and income in a medical care savings account established in accordance with 15-61-201 or withdrawn from an account for eligible medical expenses, as defined in 15-61-102, of the taxpayer or a dependent of the taxpayer or for the long-term care of the taxpayer or a dependent of the taxpayer;

(k) principal and income in a first-time home buyer savings account established in accordance with 15-63-201 or withdrawn from an account for eligible costs, as provided in 15-63-202(7), for the first-time

purchase of a single-family residence;

(l) money, not exceeding $3,000 for each taxpayer, contributed to a family education savings program account established in accordance with 15-62-201;

(m) principal withdrawn from an account for qualified higher education expenses, as defined in 15-62-103, for a designated beneficiary of the taxpayer;

(n) the recovery during the tax year of any amount deducted in any prior tax year to the extent that the recovered amount did not reduce the taxpayer's Montana income tax in the year deducted;

(o) if the federal taxable distribution of an estate or trust is greater than the state taxable distribution of the same estate or trust, the difference between the federal taxable distribution and the state taxable distribution of the same estate or trust for the same tax period; ~~and~~

(p) income of a dependent child that is included in the taxpayer's federal adjusted gross income pursuant to the Internal Revenue Code. The child is required to file a Montana personal income tax return if the child and taxpayer meet the filing requirements in 15-30-142.

(q) principal and income deposited in a health care expense trust account, as defined in [section 3], or withdrawn from the account for payment of qualified health care expenses as defined in [section 3].

(3) A shareholder of a DISC that is exempt from the corporation license tax under 15-31-102(1)(l) shall include in the shareholder's adjusted gross income the earnings and profits of the DISC in the same manner as provided by section 995 of the Internal Revenue Code, 26 U.S.C. 995, for all periods for which the DISC election is effective.

(4) A taxpayer who, in determining federal adjusted gross income, has reduced the taxpayer's business deductions by an amount for wages and salaries for which a federal tax credit was elected under sections 38 and 51(a) of the Internal Revenue Code of 1954, as those sections may be labeled or amended, is allowed to deduct the amount of the wages and salaries paid regardless of the credit taken. The deduction must be made in the year that the wages and salaries were used to compute the credit. In the case of a partnership or small business corporation, the deduction must be made to determine the amount of income or loss of the partnership or small business corporation.

(5) Married taxpayers filing a joint federal return who are required to include part of their social security benefits or part of their tier 1 railroad retirement benefits in federal adjusted gross income may split the federal base used in calculation of federal taxable social security benefits or federal taxable tier

1 railroad retirement benefits when they file separate Montana income tax returns. The federal base must
2 be split equally on the Montana return.

(6) A taxpayer receiving retirement disability benefits who has not attained age 65 by the end of the tax year and who has retired as permanently and totally disabled may exclude from adjusted gross income up to $100 a week received as wages or payments in lieu of wages for a period during which the employee is absent from work due to the disability. If the adjusted gross income before this exclusion and before application of the two-earner married couple deduction exceeds $15,000, the excess reduces the exclusion by an equal amount. This limitation affects the amount of exclusion, but not the taxpayer's eligibility for the exclusion. If eligible, married individuals shall apply the exclusion separately, but the limitation for income exceeding $15,000 is determined with respect to the spouses on their combined adjusted gross income. For the purpose of this subsection, "permanently and totally disabled" means unable to engage in any substantial gainful activity by reason of any medically determined physical or mental impairment lasting or expected to last at least 12 months.

(7) Married taxpayers who file a joint federal return and who make an election on the federal return to defer income ratably for 4 tax years because of a conversion from an IRA other than a Roth IRA to a Roth IRA, pursuant to section 408A(d)(3) of the Internal Revenue Code, 26 U.S.C. 408A(d)(3), may file separate Montana income tax returns to defer the full taxable conversion amount from Montana adjusted gross income for the same time period. The deferred amount must be attributed to the taxpayer making the conversion. (Subsection (2)(f) terminates on occurrence of contingency--sec. 3, Ch. 634, L. 1983.)"

NEW SECTION. **Section 13. Department to seek commissioner's ruling or opinion -- certification to secretary of state.** The department of administration shall, as soon as practicable, request in writing a ruling or opinion from the commissioner of internal revenue as to whether the employee welfare benefit plan created under [sections 1 through 10] is a qualified plan pursuant to section 501(c)(9) of the Internal Revenue Code. If the commissioner determines that the plan is qualified for a tax exemption, the department shall immediately certify that fact to the secretary of state and shall notify the code commissioner of the certification.

NEW SECTION. **Section 14. Loan from board of investments.** To pay the startup costs of the plan

established under the Voluntary Employees' Beneficiary Association Act, the department of administration is authorized to receive a loan from the intercap revolving loan program adopted by the board of investments pursuant to 17-5-1605.

NEW SECTION. **Section 15. Codification instruction.** [Sections 1 through 10] are intended to be codified as an integral part of Title 2, chapter 18, and the provisions of Title 2, chapter 18, apply to [sections 1 through 10].

NEW SECTION. **Section 16. Saving clause.** [This act] does not affect rights and duties that matured, penalties that were incurred, or proceedings that were begun before [the effective date of this act].

NEW SECTION. **Section 17. Effective dates.** (1) Except as provided in subsection (2), [this act] is effective on passage and approval.

(2) [Sections 7 through 12] are effective on the date that the secretary of state receives certification from the department of administration pursuant to [section 13] that the commissioner of internal revenue has determined that the plan established pursuant to [sections 1 through 10] is qualified for a tax exemption pursuant to section 501(c)(9) of the Internal Revenue Code.

- END -

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